No. 12,436

IN THE

United States Court of Appeals

FOR THE NINTH CIRCUIT

PACIFIC MAGNESIUM, INC. (formerly Socal Magnesium, Inc.),

Appellant,

vs.

HARRY C. WESTOVER, Individually and as Collector of Internal Revenue for the Sixth District of California,

Appellee.

REPLY BRIEF FOR THE APPELLANT.

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The lower court, by taking a myopic view of the case, has overlooked the controlling facts, and has decided the case on extraneous or subordinate facts. The appellee's brief tries to perpetuate that error.

The one fact which overshadows all others and should control the decision, is that Mr. Sheedy, who owned all the stock of the debtor and creditor corporations (appellant and Foundry, respectively) arranged, by an enforceable contract, to have the creditor corporation gratuitously cancel $35,335.07 of the debt owing by appellant. This forgiveness was positively to be made without any opportunity for the two corporations, or the new owner of Foundry, to negotiate about the amount of the debt, or the ability of the debtor to pay it.

After this contract was signed, appellant would certainly not think of paying any of the $35,335.07, as Gaines indemnified appellant against paying any of said amount. Consequently, it made no accord and satisfaction of *said* amount, by paying $4,000.00 on a larger debt, or otherwise.

After the contract was signed, Foundry could not hope to collect any of the $35,335.07 from appellant, as Foundry's sole stockholder Sheedy, had caused Foundry to give up said claim.

After the contract was signed, Gaines could not hope to have Foundry collect the $35,335.07 from appellant or Sheedy, because Gaines had not paid for said account, and had agreed that it would be taken out of Foundry.

After Gaines became the stockholder of Foundry, all that the new Board of Directors of Foundry could do, respecting appellant's debt, was to rubber-stamp the deal that had been made; a deal that Foundry, without consideration, would dispose of an asset which Gaines did not buy, and which Sheedy wanted transferred to appellant. The new Board of Directors of Foundry had to approve this deal, though they knew that appellant owed $39,335.07, and had sufficient assets to pay the account in full. They knew that Foundry was making a gratuitous transfer of $35,335.07 to appellant, because Foundry's sole stockholder directed it to do so.

The above are the controlling facts, and lead to only one conclusion—that Foundry made a gift to appellant because Sheedy wanted it to; or that Sheedy contributed capital to appellant, indirectly through Foundry, or directly by a contract made for appellant's benefit.

The lower court's conclusions are insupportable, when the contract is fully considered.

When the full force of the contract is considered, the trial judge's finding and conclusions, are seen to be excuses for an erroneous conclusion, rather than sound and logical conclusions from the one dynamic fact in the case.

In amplification of the above points, the appellant wishes to center attention on three facts which have been definitely agreed to between the parties, but which the lower court, and now the appellee, chose to regard as in doubt.

The first fact which has been agreed to, but which the lower court and appellee are treating as in dispute, has to do with the amount of indebtedness from appellant to Foundry.

The balance sheet of appellant at October 31, 1944, taken from its books, shows that it owed Foundry $39,-335.07. This balance sheet appeared as Exhibit 2 of the Stipulation of Facts, Record 44 and 54. P. H. Sheedy was president and a director of both companies and obviously was familiar with the books and the inter-company accounts.

Record 50 states that "Mr. Gaines acknowledges that he has been given full opportunity to inspect the books and records of Socal Foundry. * * *" Therefore, he was familiar with the inter-company accounts also.

The contract [Appellant's Ex. 1] stated that the inter-company debt from appellant to Foundry was in the approximate amount of $39,335.07. [Record 48.]

The parties hereto, after investigating the matter, entered into a stipulation that the actual debt from appellant to Foundry at November 20, 1944, was $39,335.07 [Record 43.]

The Findings of Fact signed by the District Judge stated that the inter-company debt was $39,335.07 as of November 20, 1944. [Record 27.]

The debtor and the creditor corporation were wholly owned by the same man, P. H. Sheedy, and there could be no ground for dispute between the two corporations as to the amount of the debt.

Still the lower court bases its conclusion of an accord and satisfaction in settlement of an *uncertain* amount on the following phrase in the contract: "Whereas Socal Foundry claims that Socal Magnesium, Inc., is indebted to it in the approximate amount of $39,335.07, * * *" In the same contract in clause D a definite amount is stated as follows: "To cause Socal Foundry to compromise and settle its claim against Socal Magnesium, Inc., in the aforesaid amount of $39,335.07, * * *"

In spite of this certain evidence and stipulation and findings of fact and book records to the effect that the amount owing from appellant to Foundry was $39,335.07, the court below seized upon words in the preamble to the contract, which was the only place in the entire record where any uncertainty as to the amount appears, and bases his conclusion of accord and satisfaction on it and ignores the important part of the contract which required Gaines to cause Foundry to forgive most of the debt regardless of its collectibility and regardless of its amount, and without opportunity for negotiation between the debtor and creditor.

The second settled fact which the lower court and appellee chose to treat as being uncertain, is the matter of appellant's solvency on November 20, 1944.

Here again the books of appellant showed that as of October 31, 1944, it had assets costing $110,179.86 and

liabilities, exclusive of the debt to Foundry, of $41,-877.14. This left assets of $68,302.72 available to pay Foundry's debt of $39,335.07. [Record 54.]

There is a presumption in law that appellant was solvent both before and after the cancellation of the indebtedness. (*Hasenjeager v. Voth,* 91 Cal. App. 394, 267 Pac. 146.) The court may rest assured that if appellant had been able to show that it was insolvent before and after the cancellation of the indebtedness on November 20, 1944, it would have introduced evidence to that effect.

The lower court in its finding No. 2 [Record 26, 27] held that appellant was solvent and had a clear net worth both before and after November 20, 1944. The judge refers to this in his statement of facts in his opinion.

In spite of the above positive evidence that appellant was solvent both before and after the cancellation of indebtedness, the lower court and the appellee chose to imply that the Foundry could not have collected the full debt, and that it had a loss from a bad debt, and that Foundry collected all it could from appellant, and did not cancel some of the debt "for nothing."

The lower court bases its position as to the doubtfulness of the collectibility of the debt upon the resolution adopted by Foundry at the time it made the forgiveness. In that resolution it stated: "Whereas it is the belief that the directors of this corporation that said Socal Magnesium, Inc., is unable to pay its said debt. * * *"

Now when Foundry was bound from a practical standpoint by the contract between Sheedy and Gaines to make the forgiveness, its directors had to make some statement in their minutes and this is the obvious thing they would say. Of course, it is a fact that appellant did not have sufficient cash or liquid assets to pay the debt, but it did

have sufficient assets to pay the debt, although it would have had to liquidate its capital assets to do so. Insolvency has two definitions, (1) the inability to pay its current debts, and (2) an excess of liabilities over assets. The lower court has found, as shown by the books, that appellant was not insolvent in the second sense, which is the meaning attributed to the word "insolvency" in connection with income tax cases involving forgiveness of indebtedness.

A third fact which is clearly established by the record but which the court below and the appellee chose to treat as unsettled, is whether Foundry and appellant were free to, and did negotiate for the payment or settlement of the inter-company account. The court below and the appellee chose to consider that there was an opportunity for a negotiation between the debtor and the creditor, both as to the amount of the account and as to the ability of the debtor to pay, and that the creditor collected all it could, and wrote off the balance as a bad debt.

The court below and the appellee chose to ignore, in this respect, the compelling force of the agreement between Sheedy and Gaines, wherein, before Gaines ever had any rights in the matter, he was required to agree that he would cause Foundry to gratuitously cancel the $35,335.07 debt, as consideration for the reduction of the purchase price of the stock of Foundry.

It is abundantly clear that the $35,335.07 debt was cancelled by Foundry, not because it could not collect any more nor because it had to compromise a claim for an uncertain amount, but because Sheedy required it do so while he still had control of Foundry.

The lower court held that Foundry was free to and did negotiate a settlement of its claim against appellant for

all that it could get, and wrote off the balance as a bad debt. The court did not fully appreciate the dynamic and vital fact that by the contract between Sheedy and Gaines, Sheedy, while still in control of Foundry, required that it cancel $35,335.07 of the debt against appellant "for nothing" in order to improve the financial condition of appellant, and hence did not see that this was a gift from Foundry, at the instance of Sheedy.

On page 12 of his brief, appellee finally recognizes that the cancellation by Foundry of the largest part of the debt, was caused by the contract between Sheedy and Gaines. Of course, appellee tries to argue that since the forgiveness of the debt by Foundry was part of the consideration for the sale of the stock, there was no gratuitous cancellation of the debt by Foundry.

But here, though appellee appears not to recognize it, he gets trapped in the point relied on by the court below, that the stockholders and the corporations are separate entities.

It is true that part of the consideration which Sheedy received for the sale of the Foundry stock to Gaines, was that Foundry would forgive $35,335.07 of the debt owing to it from appellant. It is true that Foundry suffered a detriment; it gave up a collectible, valid claim, for nothing. This was a gratuity and amounted to a gift, and was so intended by Sheedy, and hence by Foundry.

Since Foundry received nothing for that forgiveness, and Foundry did not receive its own stock transferred from Sheedy, then who really did suffer the detriment which was imposed on Foundry? Did Gaines suffer by the cancellation? Did he buy the stock of Foundry thinking that the claim against appellant was good, and then find disappointment in learning that the account was not fully col-

lectible? No! He paid $35,335.07 less for the stock of Foundry than he would have, if he had expected to collect that claim from appellant.

Who then did suffer for the detriment sustained by Foundry? Obviously, it was Sheedy, who wanted it to be done and who reduced the selling price of his Foundry stock by $35,335.07. He did this so as to benefit appellant.

The fact, then, that the cancellation by Foundry was part of the consideration received by Sheedy for the sale of his stock, does not prove that Foundry received consideration for the cancellation. On the contrary, since Foundry did not receive any part of the stock or any other consideration, it shows that the cancellation by Foundry, as compelled by the contract, was gratuitous and was a transfer to appellant of something for nothing.

Appellee argues on page 11 of his brief that Foundry's intent was decisive as to whether it intended to make a gift. That is true, but again we go back to the question, "Who caused Foundry to make the gift?" Was it Sheedy or was it Gaines? After Gaines came into ownership of the stock of Foundry, did Foundry have a free opportunity to collect all that was owing to it, or was it bound by a pre-existing contract, made before or at the time Sheedy sold the stock, by which the latter decreed that the forgiveness would be made under certain specified terms and without any opportunity for further negotiation?

Of course, the latter is true. After Gaines obtained possession of the Foundry stock, neither he nor Foundry had any opportunity to negotiate with appellant as to the inter-company debt, but they were bound to cancel $35,335.07 of the debt, although it was fully collectible and was certain in amount.

Appellee also argues on page 11 of his brief that since Foundry received no tax benefit from writing off the amount as a bad debt, this represents its unbiased insight as to its views of the matter at the time.

Stipulation [Record 45] is to the following effect:

> "It is further stipulated that Socal Foundry had a loss for 1944, after the allowance of net operating loss carrybacks, as permitted under the provisions of Section 23(p) and 122 of the Internal Revenue Code, * * *"

In other words, it was not until after the 1945 or later year returns were filed and net operating loss carrybacks developed that Foundry knew that it would have no taxable gain or income for 1944. Consequently, at the time the 1944 return of Foundry was filed, Gaines hoped to get a tax benefit by writing off the forgiveness of appellant's claim as a bad debt.

The lower court, in its opinion [Record 20] states:

> "The actions of both corporations following the execution of the contract fit into the idea of compromise of a claim. Plaintiff cannot disclaim for itself or Sheedy what Socal did after the agreement was entered into, for the subsequent acts were necessary in order to protect the plaintiff and Sheedy and to give effect to the undertaking made by Gaines. * * *"

Now the lower court did not state what action appellant had taken which fitted into the idea of a compromise of a claim. It is true that appellant cannot disclaim Foundry's action, taken in compliance with the contract, of cancelling the $35,335.07 debt.

But beyond that, appellant did nothing which fitted into the idea of an arm's length compromise of a claim. It did not approve of Foundry's effort to get a bad debt deduction, nor did it have any responsibility for the language of the resolution adopted by Foundry's new Board of Directors.

The appellee argues on page 11 of his brief, that Sweeney's testimony contradicted the written word. Sweeney's testimony did not contradict the written instrument. It explained the motives activating Sheedy to require Foundry to make the forgiveness.

It is true that Sweeney's testimony contradicted the fact that Foundry considered that it was entitled to a bad debt deduction, but appellant is not bound by what Foundry, in the hands of Gaines, did after the debt was forgiven. The contract did not specify how Foundry was to treat the matter in its returns and did not prohibit it from claiming a bad debt deduction, but the deduction was an idea of Gaines and probably an afterthought. In any event, neither appellant nor Sheedy participated in that action and neither should be bound by it. The stipulated facts and the court's findings show that Foundry could not have had a bad debt loss.

Since Sweeney's testimony did not contradict the written instruments which Sheedy and appellant entered into, and do not contradict anything that Sheedy or appellant did, and since there was no evidence introduced by the appellee which disputed Sweeney's testimony and since his testimony was not clouded up on cross-examination, it should be accepted.

The Supreme Court has said that the forgiveness of a debt is either income or a gift, dependent upon the intent of the creditor. Sweeney testified to the motives actuating

the creditor; namely, that Foundry gratuitously forgave the debt because its sole stockholder, Sheedy, wanted it to do so, in order to benefit appellant.

On page 12 of his brief, appellee says that there is no evidence that Sheedy intended Foundry to make a gift. But the testimony showed that Sheedy wanted to improve appellant's financial condition and that he caused Foundry to forgive, without consideration flowing to Foundry, a certain and fully collectible debt of $35,335.07. This constitutes positive evidence that Foundry intended to make a gift to appellant of $35,335.07.

On page 15 of his brief, appellee in arguing that there was no capital contribution to appellant by Sheedy, states that Sheedy released nothing to appellant and hence could not make a contribution to its capital.

Appellee ignores appellant's argument, made in its opening brief, that Sheedy made a contract with Gaines for the benefit of a third person, namely appellant, and that such contract was enforceable by appellant, and was worth $35,335.07 to appellant and that appellant realized that amount therefrom. This was a *direct* gift from Sheedy to appellant and constituted a capital contribution from Sheedy to appellant. The appellee chose not to answer this argument, as it shows a direct contribution from the sole stockholder of appellant to it of a contract right which was worth $35,335.07.

In summary, it is requested that the court find that Sheedy, while in control of Foundry, caused it to gratuitously forgive a certain, collectible, debt against appellant, for the purpose of benefiting appellant and that this amounted to a gift from Foundry to appellant. It is requested that the court find in the alternative, that Sheedy made a capital contribution to appellant, either indirectly,

as sole stockholder of Foundry, or directly by transferring to appellant an enforceable contract right which brought to appellant $35,335.07.

The appellant believes that the District Court surely erred in treating the $35,335.07 item as taxable income to appellant and that the decision should be reversed.

Dated at Los Angeles, California, this 7th day of April, 1950.

Respectfully submitted,

MELVIN D. WILSON,

Counsel for Appellant.